VZCZCXRO3252
RR RUEHRG
DE RUEHSO #0483/01 2591645
ZNR UUUUU ZZH
R 151645Z SEP 08
FM AMCONSUL SAO PAULO
TO RUEHC/SECSTATE WASHDC 8514
INFO RUEHBR/AMEMBASSY BRASILIA 9646
RUEHRG/AMCONSUL RECIFE 4188
RUEHRI/AMCONSUL RIO DE JANEIRO 8843
RUEHBU/AMEMBASSY BUENOS AIRES 3243
RUEHAC/AMEMBASSY ASUNCION 3490
RUEHMN/AMEMBASSY MONTEVIDEO 2768
RUEHSG/AMEMBASSY SANTIAGO 2490
RUEHLP/AMEMBASSY LA PAZ 3903
RUCPDOC/USDOC WASHDC 3168
RUEATRS/DEPT OF TREASURY WASHDC
RHEHNSC/NATIONAL SECURITY COUNCIL WASHDC

UNCLAS SECTION 01 OF 03 SAO PAULO 000483

STATE PASS USTR FOR KDUCKWORTH
STATE PASS EXIMBANK
STATE PASS OPIC FOR DMORONSE, NRIVERA, CMERVENNE
DEPT OF TREASURY FOR JHOEK, BONEILL

SIPDIS
SENSITIVE

E.O. 12958: N/A
TAGS: ECON EFIN EINV ETRD BR
SUBJECT: BRAZILIAN MONETARY POLICY-MODERATE IMPACT SO FAR

REF: 07 SAO PAULO 832

SENSITIVE BUT UNCLASSIFIED--PLEASE PROTECT ACCORDINGLY

¶1. Summary: Continuing a tightening cycle, the Brazilian Central Bank (BCB) raised the benchmark interest rate, the SELIC, for the fourth time this year. The 0.75 percentage point increase puts the SELIC at its highest level in nearly two years at 13.75 percent. While curbing domestic demand is a primary goal for the BCB's use of monetary policy, there are several factors that are likely to dampen the impact of higher interest rates on growth such as an increased access to credit, greater confidence in the BCB and in Brazilian economic stability, and the recent upgrade to investment grade. Even though there appears to be some slight moderation in growth of retail and consumer credit, investment shows little sign of slowing down. End Summary.

What's the Purpose?

¶2. (U) The BCB's efforts to use interest rates as the primary monetary policy tool have been twofold: controlling consumer price inflation and moderating domestic demand. Inflation was the primary reason for the first three SELIC rate hikes in April, June, and July. The recent decline in commodity prices and lower August inflation data (down 0.2 percentage points in the year-on-year inflation) in Brazil have somewhat alleviated future inflation concerns. However, even with inflation decreasing, concerns regarding domestic demand (8.6 percent growth in the second quarter) and GDP growth (6.1 percent) led the BCB to hike the SELIC rate by 0.75 percentage points on September 10. Rising wages, substantial job creation, and wider access to relatively cheap credit have fueled demand, leading to a surge in spending on big ticket items such as housing and cars. Most economists expect another two rate hikes before the end of the year, for a year-end SELIC rate of 14.75 percent.

Credit

¶3. (U) Credit in Brazil is expected to eclipse 40 percent of GDP by the end of this year despite a series of interest rate hikes since April totaling 2.5 percentage points. Through July, total lending grew by 32.7 percent, to approximately 37 percent of GDP. Furthermore, Itau Bank believes that credit is the most relevant

factor driving consumption with every 10 percent increase in credit leading to a one percent rise in consumption.

¶4. (SBU) BCB credit data is beginning to show signs of moderation. The declining growth rate is widespread among different consumer credit categories including mortgages, auto loans, and payroll-linked loans. According to Itau Bank economist Mauricio Oreng, the slowdown has not been greater because loan maturities have also increased. As a result, average monthly payments have not reflected the full interest rate increase.

Who's Better Off?

¶5. (SBU) Consumers face much higher average interest rates than businesses. According to Unibanco Economist Phillip Wagner, the average interest rate charged on fixed-rate loans to individuals in July was 51.4 percent per year versus 38.1 percent per year for lending to businesses because of the additional risk associated with individuals. However, there is not a direct linkage between the SELIC rate and interest rates that banks charge consumers and businesses. The spread between the benchmark SELIC rate and the rate that banks levy for consumer loans approaches 37 percent per year on average and 14.5 percent for corporate loans. (Note: See Reftel for more extensive discussion about the linkage between the SELIC and interest rates. End Note.) Moreover, delinquency rates (considered for accounts over 90 days past-due) for individuals are 7.3 percent and 1.7 percent for business loans. Corporations have more solid and transparent balance sheets than individuals, and also have higher collateral than individuals, providing an additional guarantee.

Consumers - Starting to Feel the Pain?

¶6. (U) Overall, interest rates for loans to individuals have increased by three percentage points to 51 percent per year since April, when the BCB began raising the SELIC rate; however, consumer confidence continues to climb. According to the Federagco Getulio Vargas, consumer confidence in August was up 6.2 percent over July, the highest in three years, and this is despite the 0.75 percentage point interest rate hike in the July.

¶7. (SBU) Retail sales data also confirm that consumption over the last 12 months is up 14 percent; however, the performance is not balanced across all sectors and the growth rates are starting to slow. Retail sectors that depend more heavily on credit and employment continue to grow, while those that depend on real income, such as supermarket products and personal consumer goods, have slowed. Car sales growth for August declined over the previous year, suggesting an initial slowdown because of higher interest rates. Itau believes that it is fair to expect some moderation in retail sales over the next few months.

¶8. (U) The interest rate hikes may also be changing the composition of consumer credit. The two consumer credit categories that have positive growth rates, overdraft loans (known as credito consignado in Portuguese) and credit cards, signal the exhaustion of cheaper forms of credit. The two combined totaled approximately 60 percent of credit issued to families during the month of July.

Corporations Still Investing

¶9. (SBU) Rates across all corporate loan classes averaged 27 percent per year, up approximately one percent from April. (Note: This average corporate interest rate per year includes fixed-rate loans at 38.1 percent per year that small and medium companies often utilize and floating-rate loans at 20.4 percent per year for larger corporations, among others. End Note.) Moreover, Brazilian businesses may be more willing to complete planned investments than they were in March. Investment was up 16 percent in the second quarter over the same time last year. According to a study by Bradesco, Brazil's largest private bank, 36 percent of respondents

in July, as compared with only 21 percent in March, said a SELIC rate of 15.25 percent by December (implying hikes of four percentage points since April) would not alter their investment plans. More telling, in March 39 percent said their investments would face sizeable cutbacks under the same conditions, while only 25 percent responded that way in July. While companies in Brazil announced 74 investment projects in August 2007, this year they announced 94 investments in August.

When Will the Rate Hikes Hit?

¶10. (SBU) According to Itau Bank, tighter monetary policy will probably lead to gradually slower sales growth in the second half of this year. Oreng believes consumption should decline when the job market slows, likely to come only in the last quarter of this year. Itau estimated in a recent study that, while interest rates and exchange rates dent retail sales after only three months via more expensive credit, it takes eight months for a fall in consumer confidence to reach retail sales. Octavio Barros, Chief Economist at Bradesco, told Econoff that Bradesco believes that the rate hikes this cycle would not have the same impact on investments that they did in 2004, primarily because Brazilian executives now view the Central Bank as a credible source of monetary policy.

Comment

¶11. (SBU) Despite the hikes to the SELIC rate, the current interest rates are still comparatively low for Brazilians who remember Brazil's recent history when the SELIC was well above 20 percent (in comparison, the current rate of 13.75 percent doesn't look bad). Because of the Brazilian system of splitting up payments for goods,

Brazilian consumers may focus on whether they can afford the monthly installment and pay less attention to the higher interest rate. Given the relatively new access to credit, Brazilians have less experience building credit into personal financial responsibility and spending decisions and may not respond as quickly to small movements in the interest rates. Corporations are also more likely to accept higher rates because they can pass on the higher costs to the end consumer via higher prices for their goods and services. The relatively stronger position of the Brazilian economy compared to other emerging markets, as well as investment inflows resulting from the recent upgrade to investment grade, are likely to mitigate any impacts of the higher interest rates on the Brazilian economy. While the rate hikes have shown us that the BCB is independent and capable of acting aggressively to fend off inflation, external factors may mean that the overall impact of the monetary policy is slight. The GOB may have to look towards fiscal policy to reign in an overheating economy, which may be unlikely in an election year. End Comment.

¶12. (U) This cable was coordinated/cleared by Embassy Brasilia and the Financial Attache in Sao Paulo.

WHITE